

Internal Revenue Service
memorandum

date: MAR 4 1991

to: Chief, Examination Division, Manhattan
ATTN: Lito Evora, International Examiner

from: Special Counsel (International)

subject: [REDACTED]

Tax Year [REDACTED]

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This is in response to your informal request for legal advice dated December 5, 1990. The operative facts as we understand them are as follows.

[REDACTED] is a U.S. corporation which owns a CFC, [REDACTED] (" [REDACTED] "). [REDACTED] also owns another Canadian CFC., [REDACTED] (" [REDACTED] ") a second tier subsidiary of [REDACTED].

On [REDACTED], [REDACTED] borrowed \$ [REDACTED] (U.S.) from an unrelated third party, [REDACTED]. On the same day, [REDACTED] loaned the \$ [REDACTED] to [REDACTED] which in turn loaned (with a small OID spread) the \$ [REDACTED] to [REDACTED], the latter corporate parent guaranteeing the original loan of [REDACTED] to [REDACTED].

The loan was repaid on [REDACTED] (33 days later). The transaction was disclosed in [REDACTED]'s Form 5471. [REDACTED] reported a \$ 951 inclusion of \$ [REDACTED] of deemed dividends plus a gross up of \$ [REDACTED] due to Canadian foreign taxes paid with respect to the E&P for a total of \$ [REDACTED]. [REDACTED] has taxable year ending December 31.

You have provided us with documentation showing that until [REDACTED], [REDACTED] owned as first tier, brother /sister companies, [REDACTED] (" [REDACTED] ") and [REDACTED]. In [REDACTED], [REDACTED] sold all of the stock of [REDACTED] to its 100% owned subsidiary,

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Discussion

Code § 951 (a) (1) (B) requires the inclusion in the gross income of U.S. shareholders of controlled foreign corporations, their pro rata share of the CFC's increases in earnings invested in U.S. property for the year (to the extent not excluded by 959). Code § 956 defines the amount of earnings invested in U.S. property at the close of any taxable year as "the aggregate amount of such property held, directly or indirectly, by the controlled foreign corporation at the close of the taxable year, to the extent such amount would have constituted a dividend."

Included in the definition of U.S. property under § 956 (b) (1) (c) is "an obligation of a United States person", which is most forms of indebtedness, whether or not interest bearing. There is an exception for the obligations of unrelated parties, § 956 (b) (2) (f). If the investment is made prior to June 14, 1988, indebtedness of less than one year is excluded from the definition. Treas. Reg. § 1.956-2 (d) (2) (ii) (a). If made after June 13, 1988, such indebtedness is not excluded from the definition. § 1.956-2T, T.D. 8209, adopted June 13, 1988.

In Notice 88-108, 1988-2 C.B. 445, the Service announced that final regulations under § 956 will exclude from the definition of the term "obligation" an obligation that would be an investment in U.S. property if held at the end of the CFC's taxable year if the obligation is collected within 30 days from the time it is incurred, unless the CFC holds for 60 days or more (or 120 days or more if the CFC's taxable year includes June 14, 1988) obligations which without regard to the 30 day rule would constitute an investment in U.S. property if held at the end of the CFC's taxable year.

This arrangement by the subject taxpayer is an obvious attempt at "affirmative use" of § 956 against the government.

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The loan to [REDACTED] itself was made by [REDACTED] and it is at this particular CFC where the \$ 956 adjustment is to be made. Looking only at [REDACTED] the amount of earnings invested in U.S. property at the close of its taxable year is the amount of such property "to the extent such amount would have constituted a dividend." Treas. Reg. § 1.956-1 (b) says this phrase means "dividends" as described by § 316 and its regulations. Code § 316 defines a dividend as a distribution of property made by a corporation to its shareholders "out of its earnings and profits." Code § 964 (a) states that except as provided in § 312 (k) (4) for subpart F

purposes, earnings and profits are determined by rules substantially similar to those applicable to domestic corporations.

The materials which you sent to me include a [REDACTED] prepared comparative balance sheet for [REDACTED] for FYE [REDACTED] and [REDACTED] (L-2). This balance sheet indicates [REDACTED] retained earnings of C\$ [REDACTED]. The last item attached to the materials is a document denominated "[REDACTED]". This document indicates that the total E&P for [REDACTED] Canadian subsidiaries ([REDACTED], [REDACTED], "[REDACTED]", "[REDACTED]" and "[REDACTED]") is C\$ [REDACTED] or U.S. \$ [REDACTED]. [REDACTED] is listed as having C\$ [REDACTED] in E&P (we note the discrepancy with its audited balance sheet E&P) and net taxes deemed paid of C\$ [REDACTED]. [REDACTED] shows E&P of C\$ [REDACTED] and taxes deemed paid of C\$ [REDACTED]. [REDACTED] shows E&P of C\$ [REDACTED] and taxes deemed paid of C\$ [REDACTED].

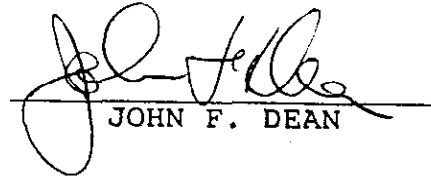
As you know, we originally questioned whether [REDACTED] had sufficient E&P to support the \$ 956 distribution in [REDACTED]. However, you recently supplied us with information concerning the sale by [REDACTED] to [REDACTED] of the [REDACTED] stock. In the sale, [REDACTED] received "stock" of [REDACTED] (they already owned 100%) and a note in an amount in excess of the combined E&P of [REDACTED] and [REDACTED]. Under § 317 (a) the note is "property" for § 304 purposes and the transaction falls under that Code section.

As a consequence, the receipt of the note by [REDACTED] is, after running the transaction through §§ 304 (b), 302 (b) and (d), treated as a § 301 distribution which is a dividend to the extent of the E&P of both the acquiring and acquired corporations, [REDACTED] and [REDACTED]. The effect is to increase the E&P of [REDACTED] for the year of the sale, [REDACTED], by the amount of the "dividends" from [REDACTED] and [REDACTED]. As we have discussed, these § 304 dividends are a species of foreign personal holding company income under § 954 (c) (1) but fit within the "same county" exception of 954 (e) (3). Therefore [REDACTED] has no § 951 inclusion in [REDACTED], there is no reduction in [REDACTED]'s E&P for [REDACTED] and all the E&P is available to support the affirmative use of § 956 in the year [REDACTED]. Nice, Huh?

It therefore appears that you have no adjustment on these facts.

- 4 -

If you have any further comments, questions or information, please call me at FTS 377-9493.



JOHN F. DEAN

cc: District Counsel, Manhattan
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